

FLEISCHMAN AND WALSH, L. L. P.

ATTORNEYS AT LAW

A PARTNERSHIP INCLUDING A PROFESSIONAL CORPORATION

AARON I. FLEISCHMAN

FLEISCHMAN AND WALSH, P. C.

CHARLES S. WALSH

ARTHUR H. HARDING

STUART F. FELDSTEIN

RICHARD RUBIN

JEFFRY L. HARDIN

STEPHEN A. BOUCHARD

R. BRUCE BECKNER

HOWARD S. SHAPIRO

CHRISTOPHER G. WOOD

SETH A. DAVIDSON

MITCHELL F. BRECHER

JAMES F. MORIARTY

MATTHEW D. EMMER

JILL KLEPPE McCLELLAND

STEVEN N. TEPLITZ

PETER T. NOONE

REGINA R. FAMIGLIETTI

TERRI B. NATOLI*

RHETT D. WORKMAN

CRAIG A. GILLEY

MARK F. VILARDO

PETER J. BARRETT

KIMBERLY A. KELLY

* VA BAR ONLY

DOCKET FILE COPY ORIGINAL

1400 SIXTEENTH STREET, N. W.
WASHINGTON, D. C. 20036

(202) 939-7900

FACSIMILE (202) 745-0916

INTERNET fw_law@clark.net

ORIGINAL FILED

RECEIVED

JUL 3 1996

July 3, 1996 FEDERAL COMMUNICATIONS COMMISSION
OFFICE OF SECRETARY

VIA HAND DELIVERY

Mr. William A. Caton
Acting Secretary
Federal Communications Commission
Washington, DC 20554

Re: CC Docket No. 96-98 In the Matter of Implementation of the
Local Competition Provisions in the Telecommunications Act of 1996

NOTICE OF EX PARTE PRESENTATION

Dear Mr. Caton:

Pursuant to Section 1.1206(a)(1) of the Commission's rules, enclosed herewith is an original and one copy of written ex parte presentations submitted today by Time Warner Communications Holdings, Inc. to Mr. James D. Schlichting, Chief, Competitive Pricing Division, Common Carrier Bureau, and to Mr. Richard K. Welch, Chief, Policy and Program Planning Division, Common Carrier Bureau.

These materials include a description of an approach for the mutual exchange of traffic between telecommunications carriers when the traffic volumes are within a zone of balance, and testimony submitted in a proceeding before the New York Public Service Commission regarding the proper calculation of avoided costs in establishment of wholesale rates.

File of Copies rec'd
JUL 10 1996

021

Mr. William A. Caton
July 3, 1996
Page 2

If there are any questions regarding these materials, please communicate directly with undersigned counsel.

Sincerely,

A handwritten signature in black ink, appearing to read "M. F. Brecher", written over a horizontal line.

Mitchell F. Brecher

Counsel for

Time Warner Communications Holdings, Inc.

Enclosures

cc: Mr. James D. Schlichting
Mr. Richard K. Welsh

41412.1/0096

FLEISCHMAN AND WALSH, L. L. P.

ATTORNEYS AT LAW
A PARTNERSHIP INCLUDING A PROFESSIONAL CORPORATION

AARON I. FLEISCHMAN

FLEISCHMAN AND WALSH, P. C.

CHARLES S. WALSH

ARTHUR H. HARDING

STUART F. FELDSTEIN

RICHARD RUBIN

JEFFRY L. HARDIN

STEPHEN A. BOUCHARD

R. BRUCE BECKNER

HOWARD S. SHAPIRO

CHRISTOPHER G. WOOD

SETH A. DAVIDSON

MITCHELL F. BRECHER

JAMES F. MORIARTY

MATTHEW D. EMMER

JILL KLEPPE McCLELLAND

STEVEN N. TEPLITZ

PETER T. NOONE

REGINA R. FAMIGLIETTI

TERRI B. NATOLI*

RHETT D. WORKMAN

CRAIG A. GILLEY

MARK F. VILARDO

PETER J. BARRETT

KIMBERLY A. KELLY

1400 SIXTEENTH STREET, N. W.
WASHINGTON, D. C. 20036

(202) 939-7900
FACSIMILE (202) 745-0916
INTERNET fw_law@clark.net

EX PARTE

* VA BAR ONLY

July 3, 1996

Mr. James D. Schlichting
Chief, Competitive Pricing Division
Common Carrier Bureau
Washington, D.C. 20554

Re: CC Docket No. 96-98 In the Matter of Implementation of the
Local Competition Provisions of the Telecommunications Act of 1996

Dear Mr. Schlichting,

Time Warner Communications greatly appreciated the opportunity to meet with you and members of your staff and to discuss its views on certain issues raised in the Commission's notice of proposed rulemaking in the above-captioned proceeding implementing the local competition provisions of the Telecommunications Act of 1996. As a follow-up to last week's meeting, we are providing you with the following information:

A baseline standard for reciprocal compensation which captures the benefits of both the recovery of costs, when warranted, and the efficiencies of Mutual Traffic Exchange when traffic is relatively in balance and the additional costs of terminating traffic are *de minimis*.

Direct Testimony of Rochelle Jones and William Dunkel filed yesterday in New York on behalf of Time Warner

Mr. James D. Schlichting
July 3, 1996
Page 2

Communications, CableVision Lightpath, TCI, and Cable Television and Telecommunications Association of New York (Case Nos. 95-C-0657; 94-C-0095; 91-C-1174). Ms. Jones' testimony provides the policy framework for Mr. Dunkel's calculations, while Mr. Dunkel's testimony identifies the appropriate level of avoidable costs and provides recommended wholesale discount levels. This is similar to the testimony submitted in a proceeding before the Tennessee Public Service Commission which was discussed with you; however, we believe the New York testimony will be more useful to you, as much of the Tennessee testimony, including the recommended discount levels, were filed subject to a protective order and therefore includes information not publicly available.

If you have any questions, please do not hesitate to call me.

Sincerely,

A handwritten signature in dark ink, appearing to read "M. F. Brecher", with a long horizontal flourish extending to the right.

Mitchell F. Brecher

FLEISCHMAN AND WALSH, L. L. P.

ATTORNEYS AT LAW

A PARTNERSHIP INCLUDING A PROFESSIONAL CORPORATION

AARON I. FLEISCHMAN

FLEISCHMAN AND WALSH, P. C.

CHARLES S. WALSH

ARTHUR H. HARDING

STUART F. FELDSTEIN

RICHARD RUBIN

JEFFRY L. HARDIN

STEPHEN A. BOUCHARD

R. BRUCE BECKNER

HOWARD S. SHAPIRO

CHRISTOPHER G. WOOD

SETH A. DAVIDSON

MITCHELL F. BRECHER

JAMES F. MORIARTY

MATTHEW D. EMMER

JILL KLEPPE McCLELLAND

STEVEN N. TEPLITZ

PETER T. NOONE

REGINA R. FAMIGLIETTI

TERRI B. NATOLI*

RHETT D. WORKMAN

CRAIG A. GILLEY

MARK F. VILARDO

PETER J. BARRETT

KIMBERLY A. KELLY

1400 SIXTEENTH STREET, N. W.
WASHINGTON, D. C. 20036

(202) 939-7900

FACSIMILE (202) 745-0916

INTERNET fw_law@clark.net

EX PARTE

* VA BAR ONLY

July 3, 1996

Mr. Richard K. Welch
Chief, Policy and Program Planning Division
Common Carrier Bureau
Federal Communications Commission
Washington, D.C. 20554

Re: CC Docket No. 96-98 In the Matter of Implementation of the
Local Competition Provisions of the Telecommunications Act of 1996

Dear Mr. Schlichting,

Time Warner Communications greatly appreciated the opportunity to meet with you and members of your staff and to discuss its views on certain issues raised in the Commission's notice of proposed rulemaking in the above-captioned proceeding implementing the local competition provisions of the Telecommunications Act of 1996. As a follow-up to last week's meeting, we are providing you with the following information:

A baseline standard for reciprocal compensation which captures the benefits of both the recovery of costs, when warranted, and the efficiencies of Mutual Traffic Exchange when traffic is relatively in balance and the additional costs of terminating traffic are *de minimis*.

Direct Testimony of Rochelle Jones and William Dunkel filed yesterday in New York on behalf of Time Warner

Mr. Richard K. Welch
July 3, 1996
Page 2

Communications, CableVision Lightpath, TCI, and Cable Television and Telecommunications Association of New York (Case Nos. 95-C-0657; 94-C-0095; 91-C-1174). Ms. Jones' testimony provides the policy framework for Mr. Dunkel's calculations, while Mr. Dunkel's testimony identifies the appropriate level of avoidable costs and provides recommended wholesale discount levels. This is similar to the testimony submitted in a proceeding before the Tennessee Public Service Commission which was discussed with you; however, we believe the New York testimony will be more useful to you, as much of the Tennessee testimony, including the recommended discount levels, were filed subject to a protective order and therefore includes information not publicly available.

If you have any questions, please do not hesitate to call me.

Sincerely,



Mitchell F. Brecher

Mutual Traffic Exchange Within a Zone of Balance

The Telecommunications Act of 1996 (the Act) requires "mutual and reciprocal recovery of costs" associated with the termination of competitors' local calls. The Act also requires that the cost of termination be based on the additional (or incremental) costs associated with terminating the call.¹ While the Act recognizes the value of a **mutual traffic exchange**, or "bill and keep," arrangement, incumbent LECs have argued that such an arrangement does not recover the costs of call termination in all cases. The best compensation arrangement would capture the benefits of both the recovery of costs, when warranted, and the efficiencies of mutual traffic exchange when traffic is relatively in balance and additional costs are *de minimis*. Such costs may even be offset by the prospect of new transaction costs which unduly burden the new entrant.

Recommended Commission Action:

The Commission's rules should provide a framework, or baseline standard, to guide parties in negotiations and state commissions in arbitration. While parties would be free to negotiate any mutually acceptable, non-discriminatory arrangements, the baseline standard would apply if arbitration by a state commission becomes necessary. The Commission should conclude that mutual traffic exchange represents the most economically efficient means for parties to meet their Section 251(b)(5) obligations for reciprocal compensation where traffic is relatively in balance. Accordingly, the Commission should require mutual traffic exchange until a mutually agreed upon, or state commission-arbitrated, threshold difference in terminating traffic is exceeded. This threshold level should take into consideration the point at which it becomes economical to incur the transaction costs associated with cash compensation, as well as non-market related conditions contributing to traffic imbalance, such as interim number portability. Additionally, the Commission should require an initial 9-12 month period of pure mutual traffic exchange while the parties put into place measurement and billing systems and review data for accuracy. This is consistent with the interim periods for mutual traffic exchange established by numerous state commissions and recognized in certain interconnection agreements.

Justification:

Incumbent LECs have asserted that mutual traffic exchange is a system of "free" interconnection which will disadvantage them in a niche-player marketplace where the balance of traffic can be significantly skewed by the new entrant. However, where traffic is relatively in balance, a system of **mutual traffic exchange** is an efficient means for recovering costs. An agreement of mutual traffic exchange provides each carrier with a tangible economic benefit that, under reasonable circumstances, surmounts a cash payment.

Where competitive providers are serving a "mass" marketplace, *i.e.*, residential and

¹ Section 252(d)(2) requires rates based upon "the additional costs of terminating...calls." (Emphasis added.) By definition, the term "additional" excludes historic (embedded) costs, as well as the costs of the "total service" (TSLRIC). The appropriate economic standard is Long Run Incremental Costs (LRIC).

small business customers as the mainstay of their market mix, traffic will naturally be "in balance," regardless of the percentage of the market served by the new entrant. Also, since all of the traffic generated today is already carried on the one existing network, the long run incremental costs of terminating that same traffic, albeit now generated by a competitor, will be *de minimis*. The transaction costs of auditing and billing compensation charges impose a relatively greater burden on new facilities-based entrants, and could exceed the benefits of a LRIC-based compensation rate

However, where competitive providers serve niche markets, such as businesses generating large volumes of traffic in one direction (*e.g.*, pizza parlors, local government offices, or telemarketing firms), traffic is likely to become out of balance. To meet incumbent LEC concerns, a zone, or threshold, may be established where traffic is presumed to be in balance. Traffic falling outside this **zone of balance** can be compensated at a rate that represents the long run incremental cost to complete each call. The zone of balance is a way of recognizing that inconsequential differences in terminating traffic do not justify the onset of transaction costs, while at the same time providing for compensation if the difference in terminating traffic flows exceeds a specified threshold level.

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

- - - - - X

Joint Complaint of AT&T Communications Case 95-C-0657
of New York, Inc., MCI
Telecommunications Corporation,
WorldCom, Inc. d/b/a LDDS WorldCom and
the Empire Association of Long
Distance Telephone Companies, Inc.
Against New York Telephone Company
Concerning Wholesale Provisioning of
Local Exchange Service by New York
Telephone Company and Sections of New
York Telephone's Tariff No. 900.

Proceeding on Motion of the Commission Case 94-C-0095
to Examine Issues Related to the
Continuing Provision of Universal
Service and to Develop a Regulatory
Framework for the Transition to
Competition in the Local Exchange
Market.

Proceeding on Motion of the Commission Case 91-C-1174
Regarding Comparably Efficient
Interconnection Arrangements for Administrative Law
Residential and Business Links. Judge Joel A.
Linsider

- - - - - X

**DIRECT TESTIMONY OF ROCHELLE JONES
ON BEHALF OF
TIME WARNER COMMUNICATIONS
HOLDINGS, INC., CABLEVISION LIGHTPATH, INC.,
TELE-COMMUNICATIONS, INC. AND CABLE
TELEVISION AND TELECOMMUNICATIONS
ASSOCIATION OF NEW YORK, INC.**

LeBOEUF, LAMB, GREENE & MacRAE,
L.L.P.
One Commerce Plaza, Suite 2020
99 Washington Avenue
Albany, New York 12210
TEL: (518) 465-1500

of Counsel:

David R. Poe
Brian T. FitzGerald

Dated: July 3, 1996

1 Q. PLEASE STATE YOUR NAME, TITLE AND BUSINESS ADDRESS.

2 A. My name is Rochelle Jones, my business address is 300 First
3 Stamford Place, Stamford, Connecticut 06902. I am Time
4 Warner Communications Holdings, Inc.'s Vice President -
5 Regulatory, for the Northeast Region.
6

7 Q. PLEASE DESCRIBE YOUR EDUCATION, BACKGROUND AND
8 TELECOMMUNICATIONS EXPERIENCE.

9 A. Prior to joining Time Warner in 1995, I was employed by
10 Southern New England Telephone Corporation ("SNET") for 17
11 years. I held several positions at SNET, including Director
12 of State and Federal Regulatory Matters, Director of
13 Strategic Planning and Finance for Consumer Markets,
14 Director of Investor Relations, and Assistant Corporate
15 Secretary. In addition, I held a number of supervisory and
16 managerial positions in Consumer Services, mechanization
17 planning for Consumer Services support systems, and
18 operations monitoring and results. I graduated from Smith
19 College in 1978.
20

21 Q. WHERE HAVE YOU TESTIFIED PREVIOUSLY?

22 A. While I have not testified in New York, I have, however,
23 testified in a number of proceedings before the Department
24 of Public Utilities Commission in Connecticut.
25
26

1 Q. ON WHOSE BEHALF ARE YOU TESTIFYING?

2 A. Time Warner Communications Holdings, Inc. ("TW Comm"),
3 CableVision Lightpath, Inc. ("Lightpath"), Tele-
4 Communications, Inc. ("TCI") and the Cable Television and
5 Telecommunications Association of New York, Inc. ("CTTANY").
6

7 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

8 A. The purpose of my testimony is to support the establishment
9 of appropriate wholesale discounts for New York Telephone
10 Company ("NYT") and Rochester Telephone Corporation ("RTC")
11 that do not distort the underlying economics of local
12 competition. I also discuss the negative impact on
13 facilities-based competitors if too steep a wholesale
14 discount is established, the potential for resellers to
15 migrate to facilities-based provision of service, the
16 definition of avoided cost, and the appropriate application
17 of cost onsets.
18

19 Q. WHY IS THE ISSUE OF RESALE DISCOUNTS IMPORTANT TO TW COMM,
20 LIGHTPATH, TCI AND THE OTHER COMPETITIVE LOCAL EXCHANGE
21 COMPANIES ("CLECS") REPRESENTED BY CTTANY?

22 A. TW Comm's and Lightpath's entry into the local exchange
23 market in New York has been as facilities-based carriers.
24 TCI is not currently certified in New York. However, that
25 company is certified in Connecticut and Illinois, and TCI's

1 current plans are to operate as a facilities-based provider
2 in New York.

3
4 In this proceeding, the Commission will establish its long-
5 term policy regarding the wholesale provision of existing
6 local exchange services. To accomplish this, the Commission
7 is creating and establishing the pricing for a new service
8 called wholesale local service. My testimony does not
9 address whether a legitimate economic justification exists
10 for the creation of a wholesale local service. Instead, my
11 testimony addresses the fact that, when the Commission
12 creates wholesale local service, the relationship between it
13 and local services sold at retail must be correctly
14 established to avoid unintended economic dislocations.
15 Here, that relationship is being expressed as a discount
16 from retail prices to arrive at the price for wholesale
17 service by incumbent LECs. That discount necessarily will
18 impact the retail opportunities of competitive facilities-
19 based providers who, lacking market power, will have to
20 sell into markets dominated by others.

21
22 In other words, in establishing wholesale rates, the
23 Commission will determine the underlying economics of the
24 entire local service market. The establishment of a
25 wholesale discount will not only determine the profitability

1 of resellers, it will directly and immediately impact the
2 risk profile of facilities-based providers. If the
3 Commission adopts an inappropriate discount that is too
4 steep, emerging competitors will turn to resale as the most
5 rational economic alternative rather than run the risk of
6 not being able to recover their cost of capital.

7
8 In addition, by setting wholesale rates for the ILEC, the
9 Commission will set the market price for competitive
10 wholesale services. If this price is too low, facilities-
11 based providers will not be able to compete in this new
12 market. The wholesale rate will determine if the
13 provisioning of wholesale services is to be a competitive or
14 effectively a monopoly service.

15
16 This proceeding is far more than a theoretical exercise. It
17 will have long-lasting and real consequences regarding the
18 viability and speed at which facilities-based local exchange
19 competition, with its ultimate consumer benefits, comes to
20 New York.

21
22 Q. PLEASE EXPLAIN HOW FACILITIES-BASED PROVISION OF SERVICE
23 WILL BE NEGATIVELY AFFECTED BY WHOLESale DISCOUNTS THAT ARE
24 TOO DEEP OR TOO GREAT?

1 A. If the Commission adopts an approach that results in deep
2 discounts for the wholesale of existing local service,
3 resellers will be guaranteed an immediate profit on local
4 services. By deep discounts, I mean, inappropriately and
5 unjustifiably large discounts. Such discounts will
6 significantly increase the risk that a competitive
7 facilities-based provider, serving the same market as the
8 resellers, will not be able to recover the large up-front
9 investment required to construct its own state-of-the-art
10 alternative local exchange network. The Commission must
11 realize that artificially-contrived wholesale rates may
12 drastically change the economics of building competitive
13 facilities.

14
15 Without the need to build a local infrastructure of their
16 own and with the ability of the most powerful resellers, the
17 IXCs, to package local and long distance services together,
18 resellers have the potential to rapidly achieve a large
19 market share. If wholesale rates are too deeply discounted,
20 resellers would be able to achieve these market share gains
21 while incurring few significant risks or costs. The fact
22 that resellers will realize such an immediate return on
23 their investment must be contrasted with the long period
24 between when investments must be made by facilities-based
25 providers and any return on those investments is realized.

1 Q. HOW DO YOU DEFINE AVOIDED COSTS FOR PURPOSES OF CALCULATING
2 THE WHOLESALE DISCOUNT?

3 A. The Telecommunications Act of 1996 requires that wholesale
4 prices for incumbent LECs be determined from the retail
5 rate, "excluding the portion thereof attributable to any
6 marketing, billing, collection and other costs that will be
7 avoided by the local exchange carrier." The phrase "any
8 other costs that will be avoided" must means those costs
9 that will actually be avoided or shed, net of the additional
10 costs that will be incurred to provide resold services. The
11 costs that will be incurred and/or retained include both
12 direct and indirect costs.

13
14 Q. RESELLERS HAVE ARGUED IN EARLIER PHASES OF THIS PROCEEDING
15 THAT THE COSTS INCURRED IN ESTABLISHING WHOLESALE SERVICES
16 SHOULD NOT BE REFLECTED IN THE WHOLESALE DISCOUNT. DO YOU
17 AGREE WITH THIS POSITION?

18 A. No. Some resellers have advocated a methodology that
19 removes the retail costs but ignores the costs associated
20 with the comparable wholesale product. Their argument is
21 flawed for several reasons. First, it starts with the false
22 assumption that the ILEC will only be in the wholesale
23 business. Second, it ignores the basic principle that the
24 cost-causer should pay, and third, it distorts the

1 underlying economics of providing local service to resellers
2 versus new facilities-based providers.

3
4 Given that the pricing methodology delineated in this
5 proceeding and in the '96 Telecommunications Act starts with
6 a retail price, it is reasonable and appropriate to conclude
7 that ILECS were meant to continue and will continue to be in
8 the retail business; and, therefore, the ILECs will not
9 avoid the costs associated with their own retail operations.
10 For example, an ILEC will continue to provide residential
11 exchange service using personnel, offices, computer systems,
12 underlying plant facilities and the indirect support
13 organizations of the company. By October, the same service
14 will be provided at wholesale and the wholesale provision
15 will require personnel, offices, computer systems,
16 underlying plant facilities and the indirect support
17 organizations of the company. Although clearly there will
18 be some cost savings associated with not having to deal with
19 retail customers; i.e., customer care functions there is no
20 reason to believe that many of the support functions and
21 facilities; i.e., billing, repair and human resources, for
22 wholesale will be more efficient than retail. In those
23 instances where new systems are being implemented and
24 efficiencies are to be gained by wholesale provisioning, the
25 cost of the new systems must be incorporated and amortized.

1 Q. PLEASE DESCRIBE HOW ADVERTISING AND MARKETING COSTS SHOULD
2 BE TREATED?

3 A. Marketing and advertising activities include functions such
4 as product development, tariff production, trade shows, as
5 well as print and commercial advertisements for products.
6 Clearly, most of these functions will continue to be
7 performed on the wholesale side, especially product
8 management. In fact, the recent resale collaborative
9 process was replete with this type of product management
10 activity, including tariff development and the investigation
11 and development of new services and functionalities (branded
12 DA, direct billing feeds and additional call detail).
13 Unfortunately, it appears that many participants in this
14 process have come to the incorrect conclusion that the
15 associated cost category primarily includes functions and
16 direct costs associated with producing an ad for a retail
17 product, such as call waiting. While there may need to be
18 an adjustment to advertising and marketing costs for
19 wholesale, the category itself remains relevant to wholesale
20 service and should not be removed.

21
22 Q. WHAT ARE SOME ADDITIONAL REASONS WHY COST ONSETS SHOULD BE
23 CONSIDERED IN THE DEVELOPMENT OF THE APPROPRIATE WHOLESALE
24 DISCOUNT?

1 A. In addition to legal arguments regarding the definition of
2 avoided costs under the Telecommunications Act of 1996,
3 which will be briefed by counsel, there are a myriad of
4 policy grounds for including cost onsets in the calculation
5 of a wholesale discount that are inherent in the degree of
6 unfairness that would be created if cost onsets were
7 ignored. At minimal cost to them, resellers would gain
8 access to all of the new systems required for the offering
9 of services for resale. In contrast, facilities-based
10 providers who will be in direct competition with the
11 resellers and the ILEC must incur the cost of developing
12 their own support systems that are developed to allow them
13 to interact with the ILEC. For example, resellers have
14 requested the ability to test resold lines on repair calls.
15 This function requires that the incumbent build a new
16 interface into its repair system. A new facilities-based
17 entrant must also invest in its own repair system to perform
18 the testing procedure. If a reseller receives this type of
19 functionality for free while a facilities-based provider
20 must incur costs for it, the underlying economics of resale
21 versus facilities-based competition would be further
22 distorted. In addition, these types of direct cost onsets
23 that are associated with resale are comparable to a
24 collocation cage for interconnection. If a new entrant
25 wants a collocation cage, there is a charger for it. A

1 decision to omit onset costs would inevitably promote resale
2 at the expense of facilities-based competition.

3
4 Q. DO YOU BELIEVE THAT RESELLERS WILL MIGRATE TO FACILITIES-
5 BASED PROVISION OF SERVICE IN THE FORESEEABLE FUTURE?

6 A. Whether or not resellers will move to facilities-based
7 provision of service depends upon the level of discount the
8 Commission ultimately adopts and the ability of resellers to
9 purchase customized local service packages or components
10 from the incumbent. Thus, this issue will be determined by
11 the Commission more than anything else. Statements by
12 resellers in this regard should be evaluated in light of
13 underlying economics rather than accepted at face value.

14
15 Q. HOW WILL THE ESTABLISHMENT OF A DISCOUNT FACTOR IMPACT THE
16 DEVELOPMENT OF A COMPETITIVE LOCAL EXCHANGE SERVICE MARKET?

17 A. Competitive markets evolve at different rates and at
18 different levels. If facilities-based competition never
19 develops, the only competition will be in areas such as
20 marketing and billing. True competition relating to network
21 efficiency and innovation will only occur if separate
22 facilities are constructed and operated. It is not a
23 foregone conclusion that the promotion of resale will jump-
24 start true competition, particularly if the development of
25 facilities-based service providers is hindered in the

1 process. Resellers will have few incentives to migrate to
2 facilities-based provision of service if a substantial
3 wholesale discount is adopted. To the extent that resellers
4 receive products, especially customized products, from the
5 ILEC at economically favorable rates they will have even
6 less incentive to construct their own facilities.
7 Consequently, adoption of an aggressive resale policy (one
8 with deep discounts and customized products) will undermine
9 the Commission's policy favoring facilities-based
10 competition. While an aggressive resale policy might
11 superficially jump-start price competition, true price
12 competition and true choice for local consumers can only
13 result from the development of robust facilities-based
14 competition.

15
16 The migration by pure resellers to facilities-based
17 provision of service will occur only if the profit margin on
18 resale does not preclude a rational economic actor from
19 accepting the financial risk necessary to construct a
20 separate local network. In other words, if a reseller can
21 make sufficient profit and acquire a real or perceived
22 customization of the resold product from the ILEC, the
23 reseller has little or no incentive to take on the financial
24 risk inherent in facility-based investment.

1 Q. DOES THE LOCAL SERVICE MARKET PROVIDE THE SAME INCENTIVES
2 FOR THE CONSTRUCTION OF FACILITIES AS THE LONG DISTANCE
3 MARKET?

4 A. No. Proponents of larger reseller discounts frequently
5 argue that the emerging IXC's extensively used resale prior
6 to building their own networks. These arguments fail to
7 take into account important cost and price structure
8 differences between the local service market and the toll
9 market. The potential to utilize the inherent capacity of a
10 single facility such as a fiber optic cable and, therefore,
11 to capture substantial revenues is far greater in the long
12 distance market than in the local market.

13
14 Q. PLEASE EXPLAIN FURTHER THE DIFFERENCES BETWEEN TOLL AND
15 LOCAL MARKETS.

16 A. In the toll market, the products being purchased for resale
17 were well established product lines (e.g., WATS, custom
18 networks) with healthy margins and proven cost structures
19 that permitted demonstrable cost savings based on volume and
20 term. The pricing structure of these services (minute of
21 use) versus the underlying cost of constructing transport
22 facilities provided the needed incentive to construct
23 separate networks. In other words, there were and remain
24 crossover points where it is more economical to construct
25 versus resell. It is also instructive to note that the

1 economics of scale and scope were recognized by the MFJ to
2 be so significant for switched access that an exception was
3 made to the underlying precept of cost based pricing for
4 dedicated and common transport. The "equal charge per equal
5 unit of traffic" policy was imposed to ensure that firms
6 with scale and scope were not permitted to exploit
7 substantial and effective discounts before competition was
8 allowed to develop. Depending on the level of discounts
9 determined in this proceeding, the same may not be true for
10 the local market
11

12 Q PLEASE PROVIDE AN EXAMPLE.

13 A. As stated above, the underlying cost structure of long haul
14 facilities is not extremely sensitive to volume. For
15 illustrative purposes, let's assume that the average
16 residential customer generates 30 minutes a month in long
17 distance minutes. Assume that in the NYC LATA, there are
18 approximately 14 million residential households. If a new
19 competitive IXC need only establish one point of presence in
20 the LATA to reach the entire market, even at a currently
21 advertised dime per minute rate with just 20 percent of the
22 market, the IXC could generate more than \$8 million of
23 revenue.
24

1 In contrast, the local market, especially the residential
2 market, shares few of these cost or revenue potential
3 characteristics. A new facilities-based provider must
4 deploy a facility into each neighborhood. Let's assume that
5 a comparable facility (a fiber optic cable) is extended to
6 500 homes. Even if the local competitor is able immediately
7 to attract 20 percent of the market, the revenue potential
8 is only in the range of \$3,000 to \$5,000.

9
10 Q. WHAT CONCLUSION SHOULD BE DRAWN FROM THE COMPARISON OF LONG
11 DISTANCE RESALE AND LOCAL RESALE?

12 A. As I have explained, the underlying economics and the
13 revenue potential for a similar investment in facilities for
14 the provisioning of long distance versus local market
15 service varies dramatically. The incentives surrounding the
16 decision to construct facilities, therefore, also differs
17 significantly. Thus, what was economically rational
18 behavior in long distance may not be the same in the local
19 market.

20
21 Q. SHOULD THE COMMISSION IMPOSE A WHOLESALE DISCOUNT THAT
22 APPLIES TO CLECS?

23 A. No. Given the ILEC's market power, its retail prices
24 effectively act as the umbrella price for all retail
25 services. Similarly, the wholesale price charged by ILECs

1 will act as an umbrella price on any other providers'
2 wholesale prices. Thus, there is no need for the Commission
3 to establish a wholesale rate for CLEC. To do so would be
4 poor policy because CLECs do not have market power and are
5 unlikely to have such power in the near future. The price
6 to resellers for the incumbent's resold services will be
7 established in this proceeding. To ensure that CLECs are
8 provided an opportunity to compete in this new market if
9 they are able, they must remain free to establish their own
10 prices. In addition, I am not aware of any legal
11 requirement that the Commission must establish a price or
12 costing methodology for new entrants.

13
14 Q. SHOULD CLECS BE REQUIRED TO OFFER SERVICE AT A WHOLESALE
15 RATE?

16 A. No. Putting aside any issues relating to the
17 Telecommunications Act of 1996, to the extent a CLEC can
18 beat the ILEC's wholesale price, it has the economic
19 incentive to do so voluntarily. The failure of CLECs, given
20 their lack of market power, to offer wholesale would have no
21 impact on the development of competition. Thus, no policy
22 justification exists for imposing such a wholesale
23 requirement on CLECs. It would be even poorer public policy
24 if CLECs were required to provide wholesale services at the
25 same discount as the ILECs. Today, many CLECs in order to

1 attract customers, price their retail services below the
2 ILEC's. Imposing a set discount off of retail would
3 effectively require CLECs to provide resellers with an
4 unjustified "double" discount.

5
6 If new facilities-based entrants are required to provide
7 wholesale services at a discount off of their already
8 reduced retail rates, they would not be able to economically
9 compete with resellers, particularly since the reseller has
10 little long-term financial investment, while the facilities-
11 based provider bears considerable facility investment risk.
12 In addition, since the new entrant's discounted wholesale
13 rate would be lower than the ILEC's wholesale rate,
14 resellers are likely to aggressively seek to purchase
15 wholesale service from the new entrant, potentially
16 straining the new entrant's finite resources. Resellers
17 would also have an incentive to demand extensive capacity
18 from the new entrant to hamper a competitive facilities-
19 based provider's ability to gain market share in the retail
20 market place.

21
22 Q. ARE THERE OTHER REASONS WHY REQUIRING CLECS TO PRICE RESOLD
23 SERVICES AT A DISCOUNT WOULD BE IRRATIONAL?

24 A. Yes. Many new entrants provision their retail service
25 through a combination of their own facilities and through